Property Finance: An International Approach

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Loan Agreement

Chapter 3

Agenda

3.1 Object and purpose of the loan

Object	*"Subject to the terms of this agreement the Lender makes available to the Borrower a medium term loan facility for the amount up to the commitment."*
Purpose	*"The Loans may only be used for financing the construction cost of the properties."*

3.2 Conditions precedents

Common conditions precedent to effectiveness and to initial funding are the following:

- **Constitution**, i.e. a certified true copy of the constitutional documents of the borrower entity
- **Certificates**, i.e a good standing certificate of the borrower entity issued by the competent companies register, including a non-insolvency statement
- **Legal opinions**

The lender is not obliged to provide any further funding tranche until some conditions are fulfilled to his satisfaction, i.e.:

- **Funding Notice**: the borrower has delivered a funding notice requesting the funding portion
- **Commitment**: the principal outstanding after providing the funding portion will not be greater than the commitment amount
- **No default clause**: no default or event of default has occurred or will result from the funding portion being provided
- **Authorizations**: all corporate authorizations which are required to be obtained by the borrower to deliver the funding notice have been obtained

3.3 Loan amount

- ✓ Depending on:
  - the project which the loan is intended to fund, and hence the value and/or construction cost of the property
  - the collateral provided
  - the borrower's creditworthiness
- ✓ This amount may be granted in one single line of credit, or through secondary lines
- ✓ For loans intended to pay for the construction costs of a property, the amount will be specified in the agreement, and will be drawn down in line with the state of progression of work. The amount which is actually drawn down will depend upon the covenants (including in particular LTC, LTV, DSCR and ICR)
- ✓ The lenders make available to the borrowers a term loan facility in an aggregate amount, that can be drawn down in different tranches, equal (for example) to the lower of:
  - the total commitments
  - 70% of the cost
  - 50% of the initial value of the properties

3.4 Interest Rates

- ✓ Loan agreement interest rate specification includes the standard rate (base rate plus margin) and the default rate
- ✓ Two major classes of loan agreements with regard to the standard interest rate: fixed-rate loans and floating-rate loans
- ✓ Negotiation of the type of interest rate and the spread between the parties (clearly that the more risky the operation, the higher the spread), since the spread must remunerate the bank's intermediation services and absorb the credit risk component
- ✓ Reference rates for the actual interest rate:
  - If a fixed rate is chosen, the IRS rate is often used
  - If a floating rate is chosen, in the Euro countries the reference rate will be the EURIBOR, whilst for other major currencies the LIBOR is used
- ✓ Application of a default rate if the borrower delays any payment, determined as the sum of the interest rate and a negotiated overdue margin and calculated on the number of days of delay in the payment

3.4 Interest rate hedging

3.4.2 Interest Rate Cap

Instrument for hedging against the risk of an interest rate rise in order to ensure that debt servicing remains at sustainable levels:
the borrower will continue to pay the floating rate whilst he will also acquire generally from a bank for a fee the right to apply an Interest Rate Cap.
If the interest rate exceeds the agreed Cap, a third party will pay the bank the difference between the IRC and the actual interest rate at the time each installment falls due.

3.4 Interest rate hedging

3.4.2 Collar

Combination of a Cap and a Floor (the latter being the exact opposite of a Cap, in that it sets a minimum interest rate rather than a maximum rate), creating a variation range for the interest rate.

Time		**1**	**2**	**3**	**4**	**5**	**6**	**7**
Spread	a	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
Cap	b	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%
Floor	c	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Eurirs	d	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
Euribor	e	2.50%	2.75%	3.25%	4.75%	4.00%	2.25%	0.75%
Difference	f = d - e	1.50%	1.25%	0.75%	-0.75%	0.00%	1.75%	3.25%
Fixed rate	**g**	**6.00%**	**6.00%**	**6.00%**	**6.00%**	**6.00%**	**6.00%**	**6.00%**
Floating rate	h = a + e	4.50%	4.75%	5.25%	6.75%	6.00%	4.25%	2.75%
Cap	i = min (b; h)	4.50%	4.75%	5.25%	6.50%	6.00%	4.25%	2.75%
Floor	j = max (c; h)	4.50%	4.75%	5.25%	6.75%	6.00%	4.25%	3.50%
Collar	k = max (if (b>h; h; b); c)	4.50%	4.75%	5.25%	6.50%	6.00%	4.25%	3.50%
Fixed - Floating	*l = g - h*	*1.50%*	*1.25%*	*0.75%*	*-0.75%*	*0.00%*	*1.75%*	*3.25%*
Fixed - Cap	*m = g - i*	*1.50%*	*1.25%*	*0.75%*	*-0.50%*	*0.00%*	*1.75%*	*3.25%*
Fixed - Floor	*n = g - j*	*1.50%*	*1.25%*	*0.75%*	*-0.75%*	*0.00%*	*1.75%*	*2.50%*
Fixed - Collar	*o = g - k*	*1.50%*	*1.25%*	*0.75%*	*-0.50%*	*0.00%*	*1.75%*	*2.50%*

A transaction incorporating a Collar will entail **the purchase of a Cap and the sale of a Floor.**

3.4 Interest rate hedging

3.4.2 Interest Rate Swap (A)

Exchange of interest rate payments between two parties seeking hedge against changes in the interest rate: this exchange of interest payments is calculated on a certain agreed reference principal (notional) for a predetermined period of time.

The contracting parties will exchange interest rate payments based on a fixed rate and a floating rate, whereby the fixed rate is due to the seller and the floating rate is due to the buyer. The difference between the two rates will establish the amount payable and the party to which it will be due.

3.4 Interest rate hedging

3.4.2 Interest Rate Swap (B)

Given a floating-rate loan with interest tracking the EURIBOR 3 month rate, a 5 year IRS is bought at a fixed rate. Under the terms of the agreement entered into prior to drawdown, the borrower will pay to the bank the fixed-rate interest payments (equal to 2.50%) at each maturity date and will receive the floating-rate interest payments, calculated on the basis of the EURIBOR 3 month fixing.
In the example, the borrower will use the interest payments received in order to pay interest on the loan where the EURIBOR 3 months exceeds the IRS.

Notional	**€ 10,000,000**			
Period (A)	**Floating-rate (B)**	**Fixed-rate(C)**	**Difference % (B-C)**	**Net flow**
1°	2.20%	2.50%	(2,2% - 2,5%) = -0,3%	**-€ 30,000**
2°	2.40%	2.50%	(2,4% - 2,5%) = -0,1%	**-€ 10,000**
3°	2.60%	2.50%	(2,6% - 2,5%) = 0,1%	**€ 10,000**
4°	2.50%	2.50%	(2,5% - 2,5%) = 0%	**€ 0**
5°	2.70%	2.50%	(2,7% - 2,5%) = 0,2%	**€ 20,000**

3.5 Loan allocation

Loans relating to property portfolios providing for loan redemption through the sale of individual properties will allocate the debt to individual properties in an **Allocated Loan Amount (ALA)** table. If the borrower sells one of the properties, the seller will be required to repay an amount equal to a percentage (greater than 100% and defined as the release factor) of the debt allocated to the property mortgaged which has been sold.

Properties	10
Single property value	€ 100
Portfolio value	€ 1,000
LTV	60%
Portfolio financed amour	€ 600
ALA per property	€ 60
Release factor %	135%
Release factor	€ 81

Disposals	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Portfolio value BoP	€ 1,000	€ 1,000	€ 900	€ 800	€ 700	€ 600	€ 500	€ 400	€ 300	€ 200	€ 100
Sale amount		€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100
Loan Balance BoP	€ 600	€ 600	€ 519	€ 438	€ 357	€ 276	€ 195	€ 114	€ 33	€ 0	€ 0
Principal repaid		€ 81	€ 81	€ 81	€ 81	€ 81	€ 81	€ 81	€ 33	€ 0	€ 0
Loan Balance EoP	€ 600	€ 519	€ 438	€ 357	€ 276	€ 195	€ 114	€ 33	€ 0	€ 0	€ 0
Portfolio value EoP	€ 1,000	€ 900	€ 800	€ 700	€ 600	€ 500	€ 400	€ 300	€ 200	€ 100	€ 0
LTV	*60%*	*58%*	*55%*	*51%*	*46%*	*39%*	*29%*	*11%*			

3.6 Repayment Schedule

- ✓ Range of mandatory repayment procedures:
  1. bullet payments
  2. interest-only repayment plans (semi-bullet)
  3. balloon payments
  4. fixed repayment plans
- ✓ Repayment of the amount borrowed may be made either in advance by the borrower in one single installment, or alternatively the borrower or the lender may request that advance payment may be made if certain prerequisites are met
- ✓ Optionality between mandatory or voluntary prepayments

3.7 Fees

- ✓ **Arrangement Fee**
- ✓ **Commitment Fee**
- ✓ **Agency Fee**
- ✓ **Syndication Fee**
- ✓ **Prepayment and Cancellation Fee or Early Repayment Fee**

Loan Amount	€ 1,000,000	Agency Fee	€ 500
Arrangement Fee	1.10%	Syndication Fee	€ 700
Commitment Fee	0.45%	Fixed Interest Rate	5.00%

Time	**0**	**1**	**2**	**3**	**4**	**5**
Loan Balance BoP		€ 350,000	€ 650,000	€ 850,000	€ 1,000,000	€ 550,000
Committed amount	€ 1,000,000	€ 650,000	€ 350,000	€ 150,000		
Drawdown %	35%	30%	20%	15%		
Drawdown	€ 350,000	€ 300,000	€ 200,000	€ 150,000	€ 0	€ 0
Repayment %					45%	55%
Repayment					€ 450,000	€ 550,000
Loan Balance EoP	€ 350,000	€ 650,000	€ 850,000	€ 1,000,000	€ 550,000	€ 0
Arrangement Fee	€ 11,000					
Commitment Fee		€ 2,925	€ 1,575	€ 675	€ 0	€ 0
Agency Fee	€ 500	€ 500	€ 500	€ 500	€ 500	€ 500
Syndication Fee	€ 700	€ 700	€ 700	€ 700	€ 700	€ 700
Interest	€ 0	€ 17,500	€ 32,500	€ 42,500	€ 50,000	€ 27,500
Total cash flow	*€ 337,800*	*€ 278,375*	*€ 164,725*	*€ 105,625*	*-€ 501,200*	*-€ 578,700*
Actual cost	***5.77%***					

3.8 Default events

- ✓ Non-payment
- ✓ Breach of obligation
- ✓ Misrepresentation
- ✓ Cross default
- ✓ Insolvency
- ✓ Insolvency proceedings
- ✓ Creditors' process (expropriation, attachment, sequestration, distress or execution)
- ✓ Unlawfulness and repudiation
- ✓ Cessation of business
- ✓ Compulsory purchase
- ✓ Major damage
- ✓ Material adverse change
- ✓ Acceleration

3.9 Property Insurance

The borrower is responsible for all insurance costs in order to restore the original value of the collateral property (in cases involving partial damage) or to redeem the debt in full in the event that the property provided as collateral is destroyed.

Furthermore, should the value of the collateral fall, due inter alia to a general or local fall in property prices as certified by an official surveyor's report based on objective market parameters, the contract will grant the bank a right to require that the collateral be increased accordingly, or the provision of suitable collateral and/or the partial redemption of the loan.

3.10 Duty to provide information

- ✓ The borrower is obliged to inform the lender of any disputes, arbitral proceedings or administrative procedures initiated after conclusion of the agreement which may have a detrimental effect
- ✓ The borrower may be required to inform the bank with sufficient advance notice of its intention to sell or exchange the property or to establish any other real right of possession over it.
- ✓ Examples of a disclosure obligation regard:
    - Financial statements
    - Requirements as to financial statements
    - Reports and Updated Business Plans
    - Client requirements
    - Notification of default
    - Compliance Certificate

3.11 Contractual covenants

Under a covenant a borrower will undertake not to carry out acts which could be detrimental to the rights of the bank or increase the risk of default, whereby the bank is generally granted the right to renegotiate or terminate the loan.

- ✓ Negative covenant → when the requested conditions are breached
- ✓ Positive covenant → obligation to act in such a manner as to enable the bank to monitor the loan

Balance Sheet Covenants	Commitments on the part of borrower to maintain for the loan full term : • a net balance sheet capital level not lower than a specified minimum • the ratio of total indebtedness to net capital within a given limit • a current liquidity indicator which is not lower than a specified minimum • financial charges within a specified limit of turnover
Financial Covenants	• Interest Cover Ratio • Debt Service Cover Ratio • Loan to Value Ratio • Loan to Cost Ratio • Yield on Debt • Project Cover Ratio • Loan Life Cover Ratio

3.11.1 Financial covenants

- ✓ **Interest Cover Ratio** (ICR) is the ratio between the operating income, the income gained from the lease and/or sale of the properties, and the amount of interest due to the bank on the loan over the same period
- ✓ **Debt Service Cover Ratio** (DSCR) is the ratio between the operating cash flows gained from the lease of the properties and the amount of principal and interest due to the bank
- ✓ **Loan to Value Ratio** (LTV) is the amount of the loan granted or the residual amount due to the bank as a percentage of the OMV of the property at the time the indicator is calculated
- ✓ **Loan to Cost Ratio** (LTC) means the amount of the loan granted or the residual amount due to the bank by the borrower as a percentage of the construction cost of the property at the time it was calculated
- ✓ **Yield on Debt** means the net rental payments relating to the property financed as a percentage of the amount of the loan due by the borrower to the bank at the same time (Net Operating Income/Loan amount)
- ✓ **Project Cover Ratio** (PCR) means the present value of cash flows for the entire lifetime of the project as a portion of the present value of the debt
- ✓ **Loan Life Cover Ratio** (LLCR) means the present value of cash flows between the date of valuation and the deadline for repayment of the debt and the residual debt on the date of valuation

3.11.1 Financial covenants

Property Market Value	€ 1,000
Annual MV increase	2.00%
Property Yield	7.00%
Initial LTV	65.00%
Maturity (years, max 35)	20
LTV treshold	45.00%
Interest rate	
Under LTV	Above LTV
5.00%	6.00%

	Period	0	1	2	3	4	19	20
a	Market Value	€ 1,000	€ 1,020	€ 1,040	€ 1,061	€ 1,082	€ 1,457	€ 1,486
b	Real estate CF	€ 70	€ 71	€ 73	€ 74	€ 76	€ 102	€ 104
	Loan Balance BoP		€ 650	€ 618	€ 585	€ 553	€ 65	€ 33
	Drawdown	€ 650						
	Repayment		€ 33	€ 33	€ 33	€ 33	€ 33	€ 33
c	Loan Balance EoP	€ 650	€ 618	€ 585	€ 553	€ 520	€ 33	€ 0
c/a	LTV	65%	64%	59%	55%	51%	4%	2%
	Interest rate applied		6.00%	6.00%	6.00%	6.00%	5.00%	5.00%
d	Interest paid		€ 39	€ 37	€ 35	€ 33	€ 3	€ 2
e	Debt service (instalment)		€ 72	€ 70	€ 68	€ 66	€ 36	€ 34
d/b	ICR		183%	197%	212%	229%	3138%	6401%
e/b	DSCR		100%	105%	110%	115%	285%	305%
b/c	*Yield on Debt*	11%	12%	12%	13%	15%	314%	

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